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## A USDA-ERS BRIEFING BOOKLET



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# THE BASIC MECHANISMS OF EUROPEAN COMMUNITY (EC) FARM POLICY

Illustrated by:

Target, Intervention, and  
Threshold Prices, plus  
Levies and Refunds

*How They Work*

## PREFACE

Many people -- farmers, legislators, congressional staff, lobbyists, researchers, employees of the food and fiber industry, and the interested public -- look for a quick way to understand farm policy, both domestic and foreign. This series of booklets ( listed on the back cover) is addressed to that wide audience and is intended as an introduction to the key concepts.

The booklet is meant to work like an informal briefing, made with a series of overhead transparencies. Each page contains a "screen" of illustrative material, accompanied above and below by "instructor's comments" -- followed by a question to the reader. The answer to each question will be found on the next page.

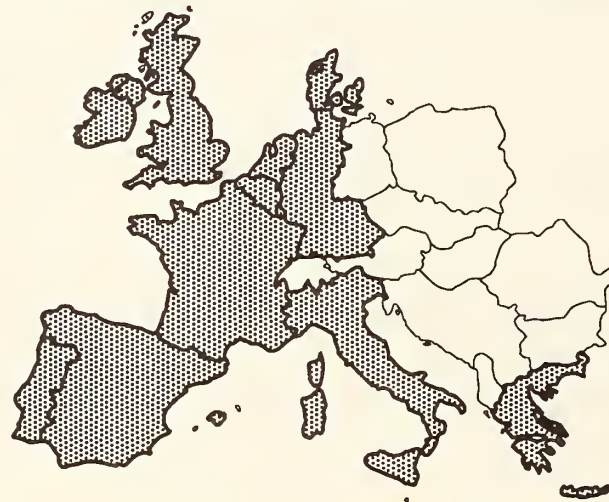
This booklet is based on materials supplied by Walter H. Gardiner of the Economic Research Service of the U.S. Department of Agriculture. Helpful comments were made by Michael T. Herlihy, David R. Kelch, William T. Coyle, and James Vertrees. It was designed and edited by William J. Hudson (The ProExporter Network, Maumee, Ohio), under contract with the Economic Research Service.

## EC AGRICULTURAL POLICY AND ITS EFFECTS

- The EC is the world's second largest exporter of agricultural products behind the United States.
- The basic mechanisms of the Common Agricultural Policy (CAP) include support prices, import levies, and export subsidies.
- The principles of common pricing and free trade among member countries were short-lived and have not been reestablished.
- Healthy increases in support prices caused production to grow faster than consumption for most commodities.
- Self-sufficiency has been achieved for many agricultural products.
- The EC has switched from being a net importer to a net exporter of many agricultural products.
- Food expenditures are substantially higher than in the United States.
- Budget outlays for agriculture have risen sixfold since 1975.
- To contain budget expenditures, the EC has implemented a number of policy reform measures since the early 1980s.
- In spite of reforms, budget expenditures are expected to reach a record 30.1 billion ECU (\$36.4 billion) in 1990.
- Dairy quotas since 1984 have cut milk production 7 percent.
- Price restraint and production stabilizers have checked grain and oilseed production slightly, though they continue on long-term trends.
- Grain exports continue to grow, while oilseed imports decline.
- After sharp declines in 1983-84, sugar production and exports are on the rise.
- The Uruguay Round of GATT negotiations and the 1992 Program pose special challenges to the future of the CAP.

*The European Community (EC) was formed by the Treaty of Rome on March 25, 1957. It began with six members and has expanded three times -- in 1973, 1981, and 1986.*

### THE EUROPEAN COMMUNITY (EC)



EC-6 (1957)

Belgium  
France  
Italy  
Luxembourg  
Netherlands  
West Germany

EC-9 (1973)

Denmark  
Ireland  
United Kingdom

EC-10 (1981)

Greece

EC-12 (1986)

Portugal  
Spain

*The EC today has a population of 325 million and a gross domestic product of \$4 trillion. The EC and the United States are each other's largest trading partner. The EC has become the world's second largest exporter of agricultural products behind the United States.*

Question. *What were the main goals of the agricultural policy adopted by the EC at its inception?*



*The Common Agricultural Policy (CAP) of the EC recognized agriculture as a key element in the Community's social structure and its overall economy.*

**OBJECTIVES OF THE CAP**  
(Article 39 of The Treaty of Rome, 1957)

- Increase agricultural productivity through technical progress and optimum utilization of labor
- Ensure fair standard of living for agricultural population, by increasing earnings of persons in agriculture
- Stabilize markets
- Guarantee regular supplies
- Ensure reasonable prices to consumers

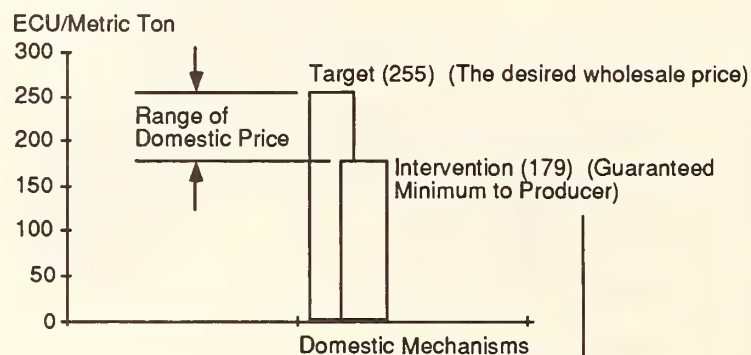
*Most of the world's industrialized nations, including those of the EC, have a stated policy goal of making farm incomes "fair" in comparison to urban incomes.*

Question. *How did the EC attempt to achieve the objectives of the CAP?*

The principal price support mechanism of the CAP was to establish Target prices for agricultural products, as well as to guarantee minimum producer prices at which government authorities would intervene and buy the products for Community storage.

### PRICE SUPPORT MECHANISM OF THE CAP

Case of Wheat (Price levels typical of 1986-89)



Note: "ECU" = European Currency Unit, a basket of EC currencies. Exchange rate questions will be considered later.

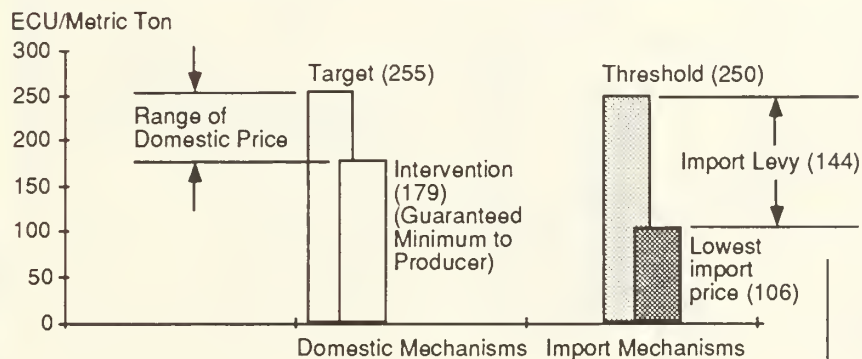
If market price falls to Intervention, farmers may sell their wheat to EC authorities for storage. Such "Intervention stocks" are held for later sale or export.

Question. Besides establishing support prices, did the CAP also seek to protect EC farmers from imported wheat?



Yes, the CAP established a Threshold price for imports, below which products could not enter the Community. The mechanism for this was to charge importers a levy on top of the product's price, as quoted by the lowest landed price for imports.

### PRICE SUPPORT MECHANISM OF THE CAP, continued Case of Wheat (Price levels typical of 1986-89)

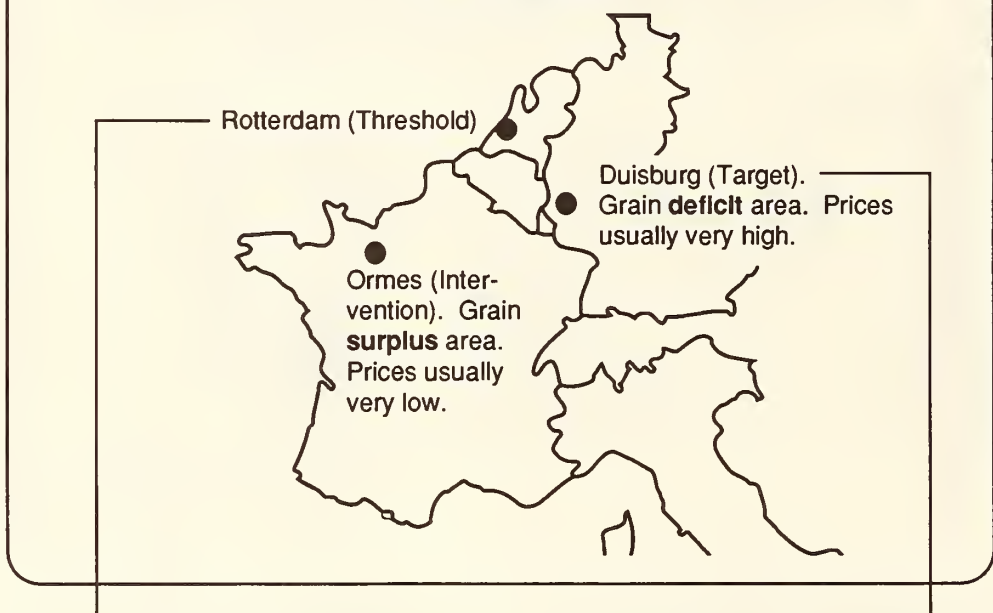


The import levy is set (daily for most commodities and weekly for others) by Community authorities in an attempt to keep producer prices above Intervention and near to Target, no matter how low the commodity's price may fall outside the EC.

Question. How did the pricing mechanism of Target-Threshold-Intervention come about? Was it originally connected to actual markets, or was it purely conceptual?

*The CAP's price support mechanism was originally linked to prevailing prices at three locations in the EC-6.*

### ORIGIN OF CAP PRICE SUPPORT MECHANISM Case of Wheat



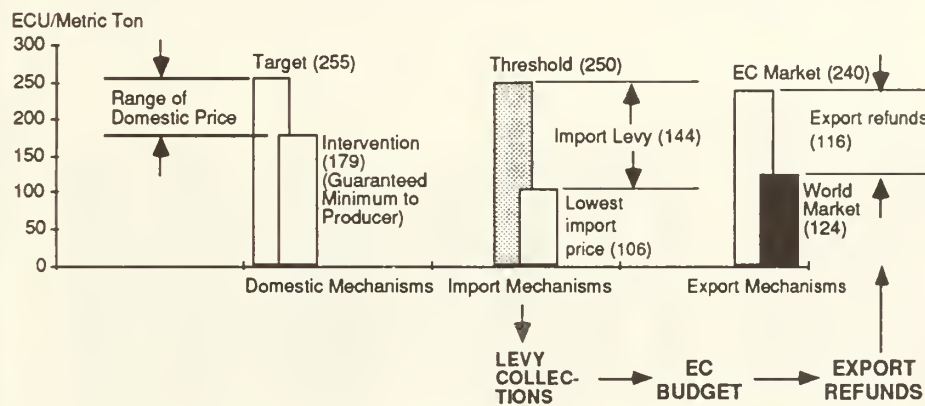
*Grain import point. Threshold price was originally set as Target price (Duisburg) minus transportation cost from Rotterdam.*

*Target price was originally set by adding marketing margin between Ormes and Duisburg to Intervention price.*

Question. *How can the EC export wheat if it maintains policy prices above world markets?*

Another feature of the CAP is export subsidies. EC exporters are given "restitutions" or "refunds" which allow the EC to sell products at world prices. These export subsidies are based on the difference between the internal EC market price and the world market price at ports where the EC exports.

### PRICE SUPPORT MECHANISM OF THE CAP, continued Case of Wheat (Price levels typical of 1986-89)



Question. How are EC prices converted from ECUs to national currencies?

Each year, the EC sets "common" policy prices in ECUs for most commodities, which are then converted into national currencies of the 12 members by special "green rates." Green rates differ from market exchange rates because of the unwillingness of EC members to allow exchange rate changes to be transmitted to their agricultural sectors.

### EC GREEN RATES AND MARKET EXCHANGE RATES, JULY 1989

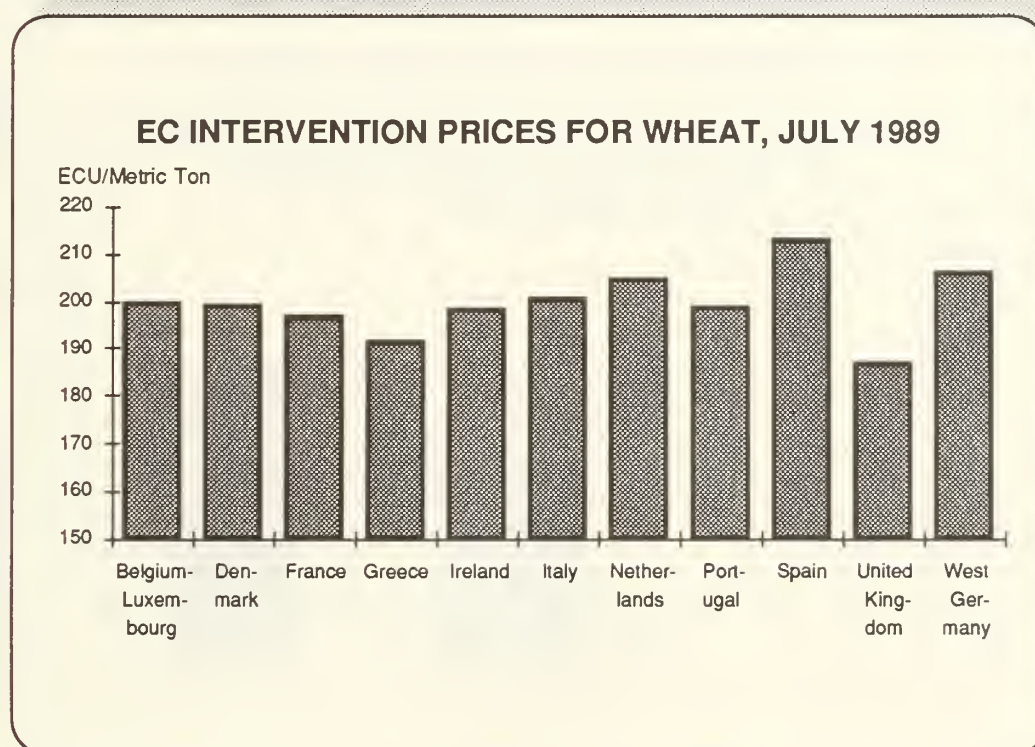
Country	Green rates	Market rates	Difference*
	Currency units per ECU		Percent
Belgium-Luxembourg	48.2869	43.4216	11
Denmark	8.93007	8.05296	11
France	7.69787	7.02904	10
Greece	190.998	179.147	7
Ireland	0.856765	0.775973	10
Italy	1673.00	1499.25	12
Netherlands	2.66089	2.336989	14
Portugal	192.002	173.551	11
Spain	154.213	130.208	18
United Kingdom	0.701383	0.674318	4
West Germany	2.37360	2.07243	15

\* (Green rate - Market rate) x 100/ Market rate

*Green rates exceeded market rates in July 1989 by as little as 4 percent in the United Kingdom and by as much as 18 percent in Spain.*

Question. What effect do green rates have on the the EC's goal of "common" pricing among member countries?

*Because of green rates, prices across member countries are not "common," an outcome which runs counter to one of the basic objectives of the CAP.*

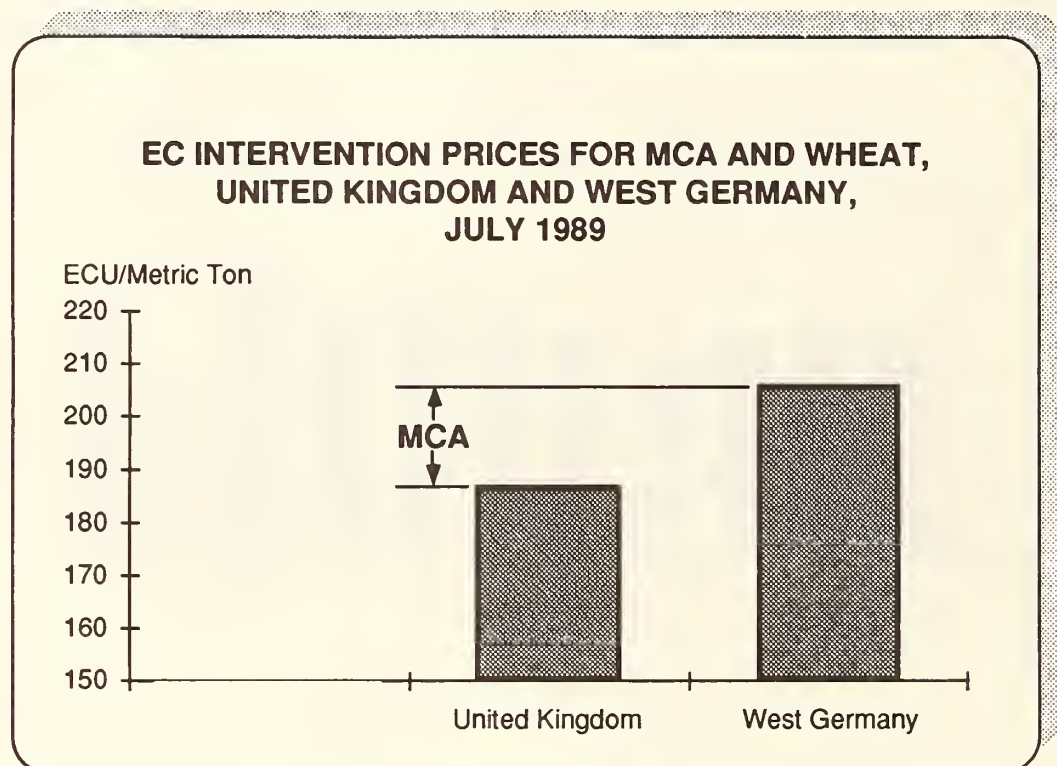


*Multiplying the EC price of 179.44 by the the green rate for each country gives the Intervention price in each country. Converting these prices back into ECUs using the market exchange rates shows the wide divergence in prices, about 14 percent between the highest and lowest.*

Question. *How does the EC prevent trade distortions caused by the breakdown of common pricing?*



*To prevent distortions caused by price differences between countries (due to the green rate system), the EC established Monetary Compensatory Amounts (MCAs), which are approximately equal to the difference in the Intervention prices between countries.*



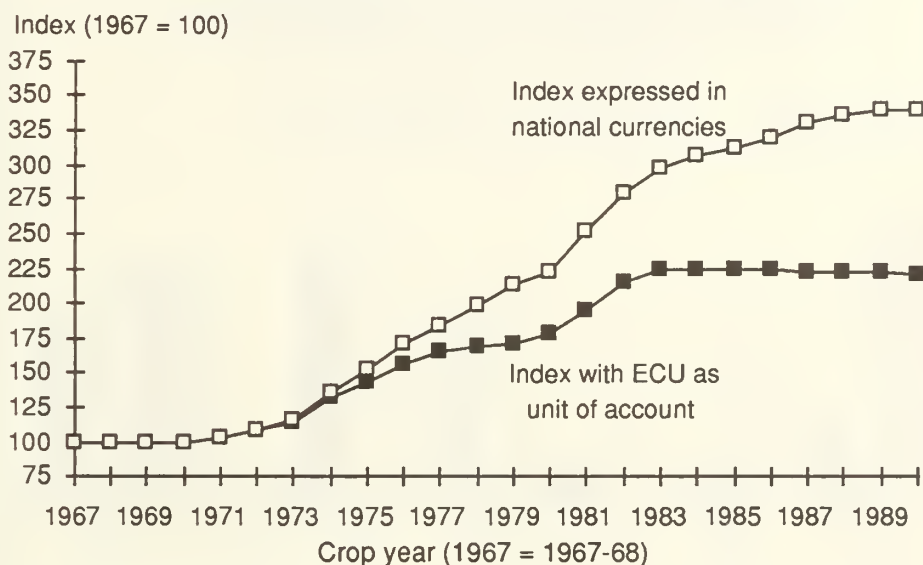
*For countries with weak currencies, like the UK in recent years, MCAs act as taxes on exports and subsidies on imports. For countries with strong currencies, such as West Germany, the effect of MCAs is just the opposite. The MCA system of border taxes and subsidies has led to the breakdown of the EC's goals of common pricing and free trade among member countries.*

Question. *What have green rates done to CAP prices over time?*



*CAP prices denominated in ECUs increased until 1984-85, when the EC began to "discipline" prices. However, prices in terms of national currencies have continued to climb.*

### EC SUPPORT PRICE INDICES, ALL COMMODITIES

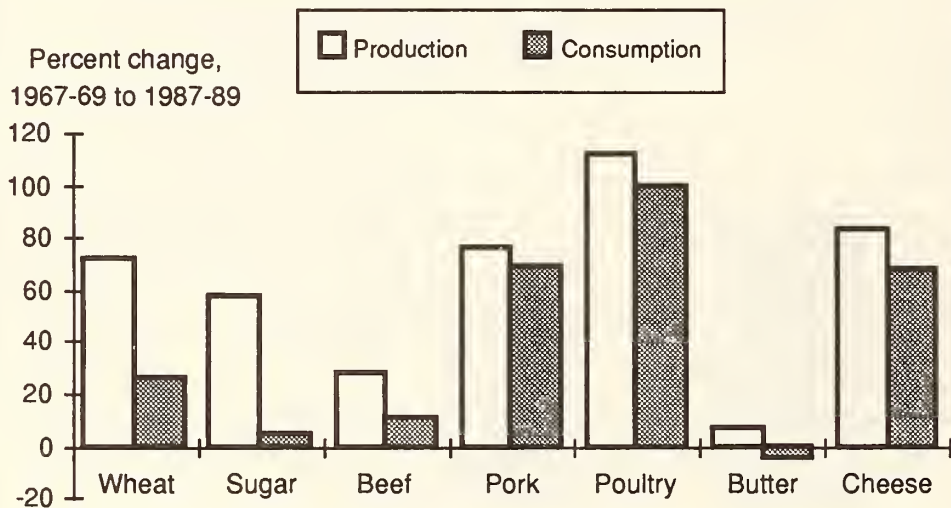


*On average, prices in national currencies have increased at an annual rate of 5.6 percent (in nominal terms) compared with a 3.6 percent increase in ECU terms since 1967.*

Question. What effect has the CAP had on the EC's agricultural sector?

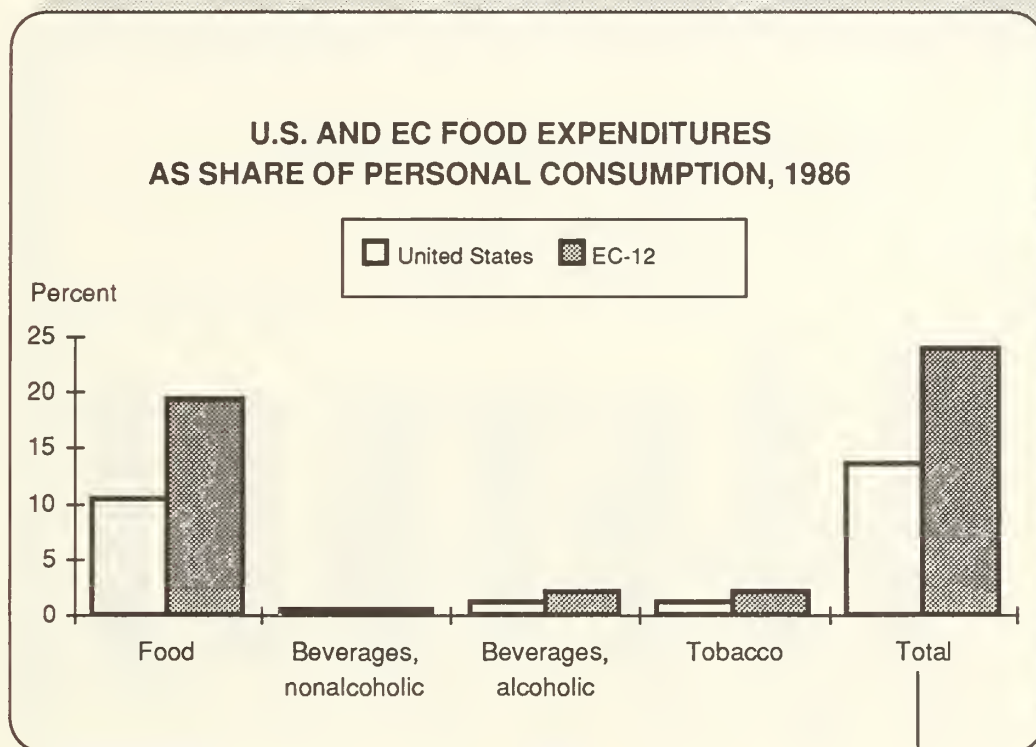
*The price support, variable levy, and export subsidy mechanisms of the CAP have provided strong incentives for investing in EC agriculture, leading in turn to significant productivity increases. At the same time, high EC prices have slowed the growth in consumption relative to production for many member countries.*

### GROWTH OF EC PRODUCTION AND CONSUMPTION, SELECTED COMMODITIES



Question. *What effect has the CAP had on the cost of food to EC consumers?*

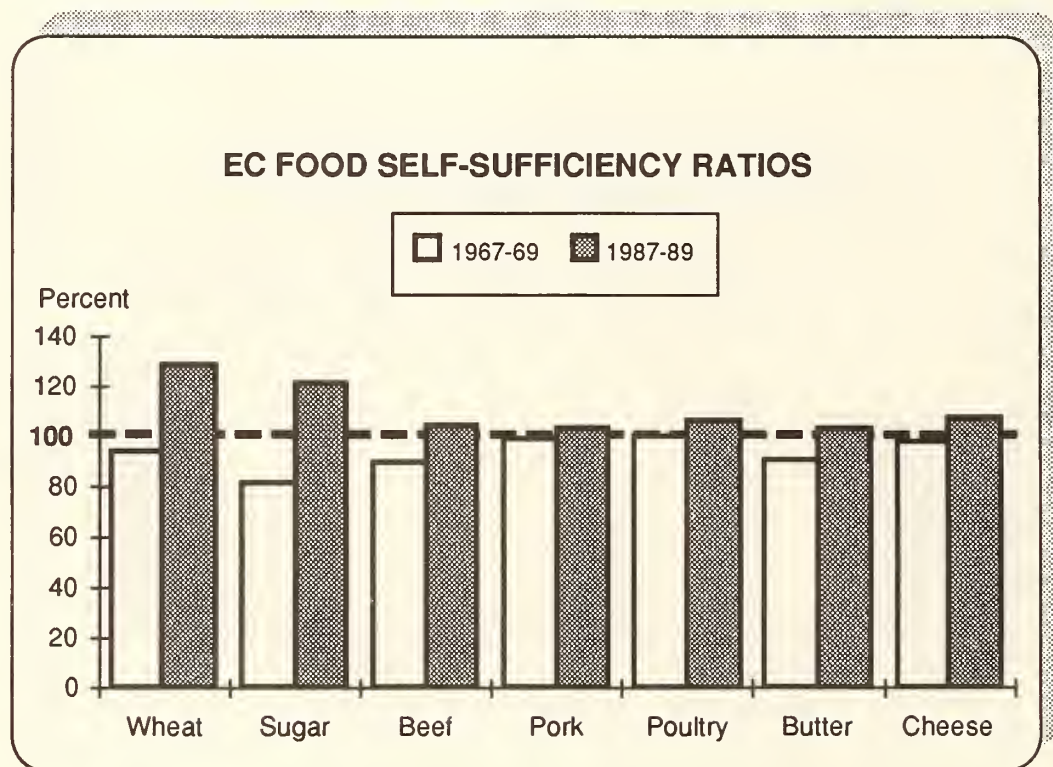
*One effect of the CAP is to raise overall food prices for consumers in the Community. Most U.S. farm programs, on the other hand, support farm income without directly raising food prices to the consumer.*



*Food costs are significantly higher in the EC than in the United States.*

Question. *Has the CAP met the goals set down for it in 1957 of increased productivity and guaranteed supplies?*

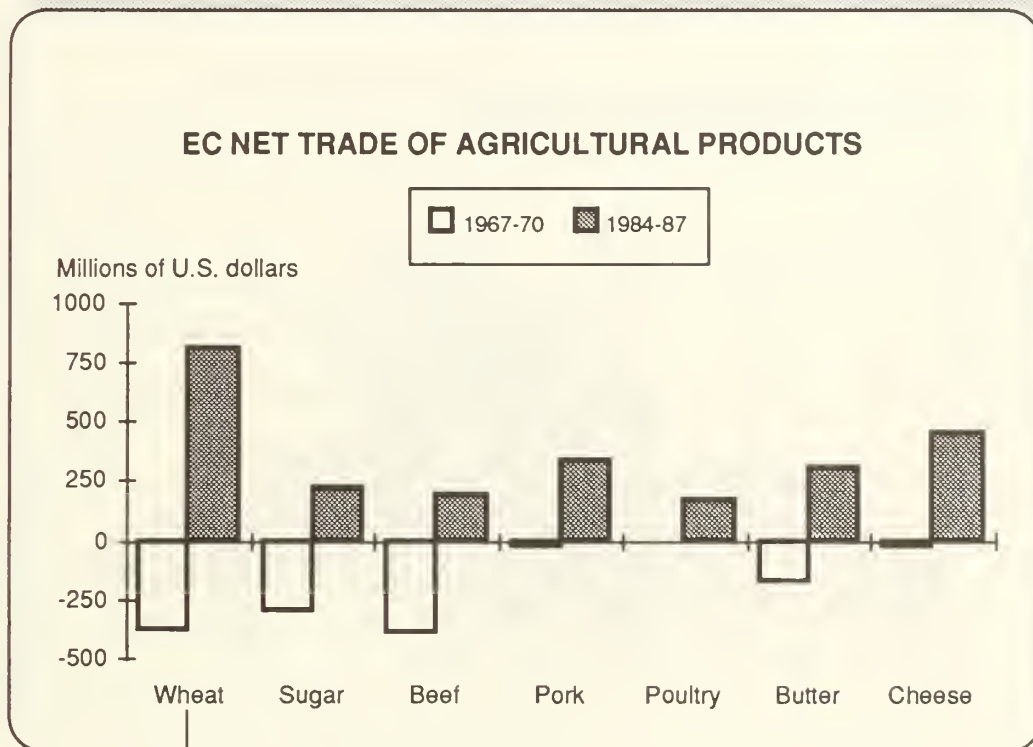
*Strong production growth in agriculture combined with slow or stagnant consumption growth has resulted in increasing self-sufficiency for a number of agricultural commodities.*



*EC self-sufficiency between the periods 1967-69 and 1987-89 has risen from 94 to 128 percent for wheat, 81 to 121 percent for sugar, and 91 to 103 percent for butter.*

Question. *What has the increased self-sufficiency done to EC trade in agricultural products?*

*Increased self-sufficiency in agriculture has changed the EC from a net importer to one of the world's largest net exporters of a number of agricultural products.*



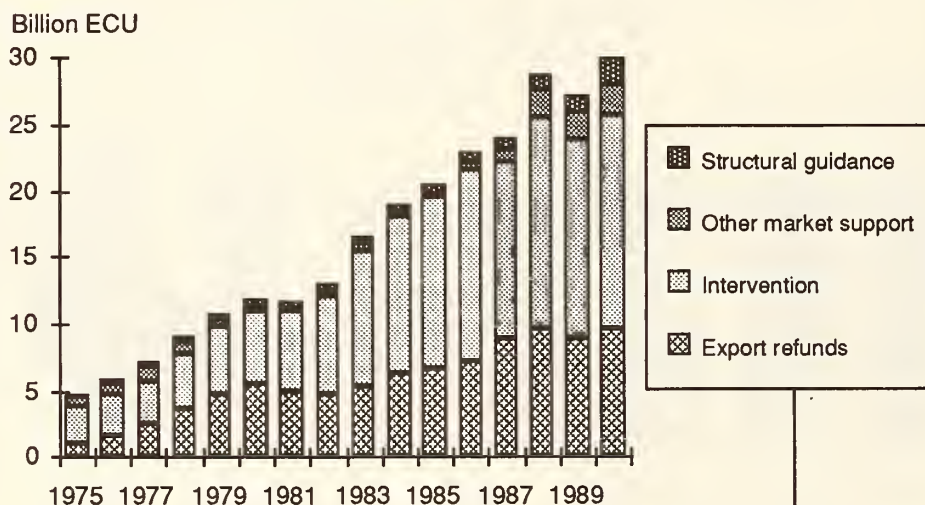
*The EC has shifted from a net importer of \$376 million of wheat in 1967-70 to a net exporter of \$817 million of wheat in 1984-87. Similar changes can be seen for many other commodities.*

Question. *How much does the EC spend on implementing its Common Agricultural Policy?*



*EC budget outlays for agriculture have grown from 4.7 billion ECU (\$5.8 billion) in 1975 to 27.3 billion ECU (\$30.1 billion) in 1989. The 1990 expenditures are estimated to reach a record 30.1 billion ECU (\$36.4 billion). These figures do not include government spending on agriculture by individual countries, which totalled 8.4 billion ECU (\$7.7 billion) per year in 1981-86.*

### CAP EXPENDITURES BY SUPPORT MECHANISM

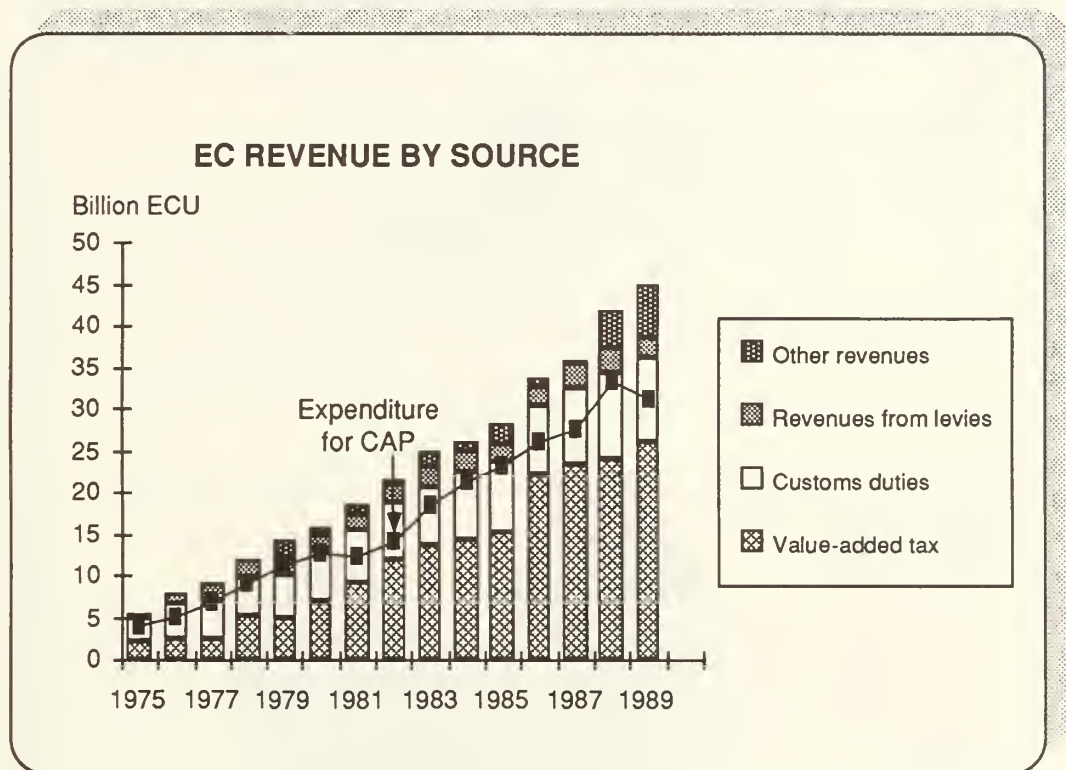


*"Structural guidance" is mainly to improve technology and infrastructure. "Intervention" includes the cost of storage, production refunds, and processing subsidies. "Other market support" includes compensation for exchange rate changes and stock disposal.*

Question. What portion of the EC budget is consumed by support for agriculture?



The CAP requires about 70 percent of the EC budget, which is shown below by source of revenue. The costliness of the CAP has led to a marked increase in the Value-Added Tax (VAT), which is a consumption tax charged in all countries.

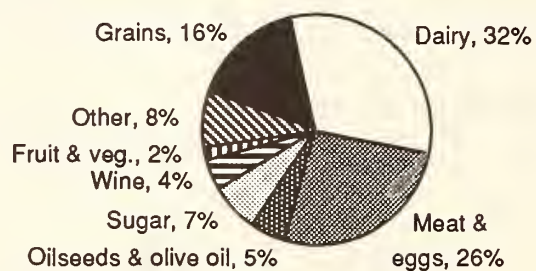


Question. How are CAP expenditures broken down by agricultural product? Are grains the most important?

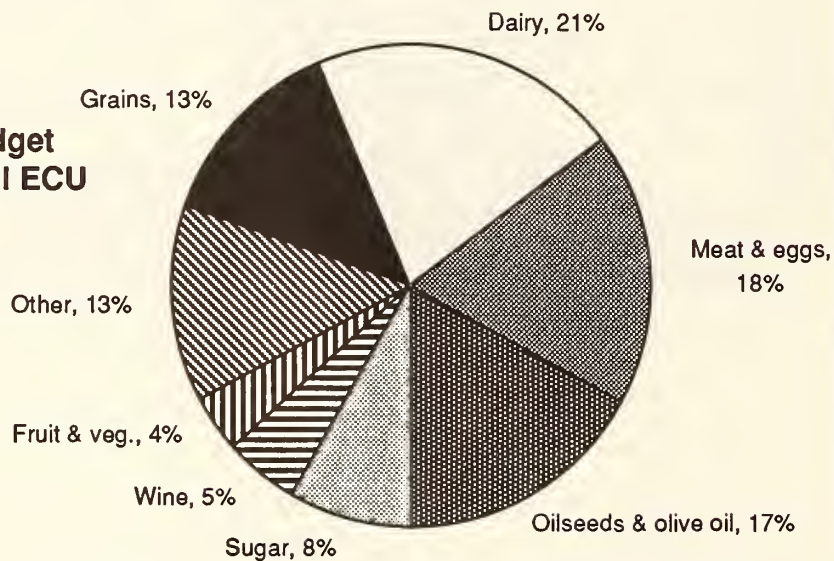
*The most important single category of expense in the CAP is dairy, followed by meat and eggs, oilseeds and olive oil, and then grains.*

### EC BUDGET EXPENDITURES BY COMMODITY (Intervention and Export Refunds Only)

**1975,  
Total budget  
of 4.5 bil ECU**



**1989,  
Total budget  
of 25.9 bil ECU**



**Question.** *What has the EC done to limit budget expenditures on agriculture and deal with commodity surpluses?*

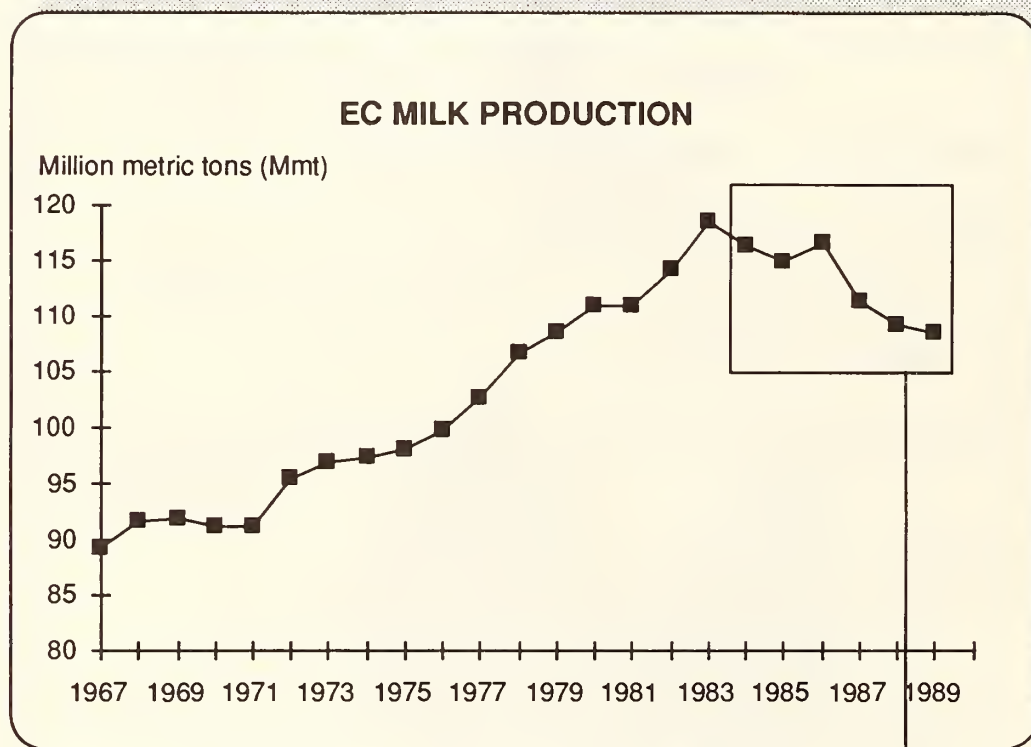
*In the 1980s, the Community began to apply quotas, price stabilizers, core-responsibility (producer) levies, and other mechanisms meant to contain the growth in budgetary expenditures and to give the market a larger role in orienting production.*

### RECENT REFORMS OF THE CAP

- 1982 Maximum Guaranteed Quantity set for rapeseed.
- 1984 Milk production quotas established.
  - Intervention prices frozen or reduced in ECUs for most commodities.
  - Smaller increases in green rates.
  - Maximum Guaranteed Quantity set for sunflowerseed.
- 1986 Coresponsibility levy of 3 percent applied to cereals sold off farm.
  - Limits on intervention of cereals and beef.
- 1987 Maximum Guaranteed Quantity set for soybeans.
  - Limits on intervention of butter and skim milk powder.
  - Buying-in price for cereals set at 94 percent of Intervention Price.
- 1988 Maximum Guaranteed Quantity set for grains and most other commodities.
  - Direct income aid to small producers.
  - Limit on annual growth rate of agricultural spending to 74 percent of the increase in Community's GNP growth rate.
  - Land set-aside program.

Question. *How effective have these reforms been?*

*As previously illustrated, while the EC has contained support prices in ECUs, prices continue to grow in terms of national currencies. Dairy quotas have succeeded in cutting milk production slightly, as shown below.*

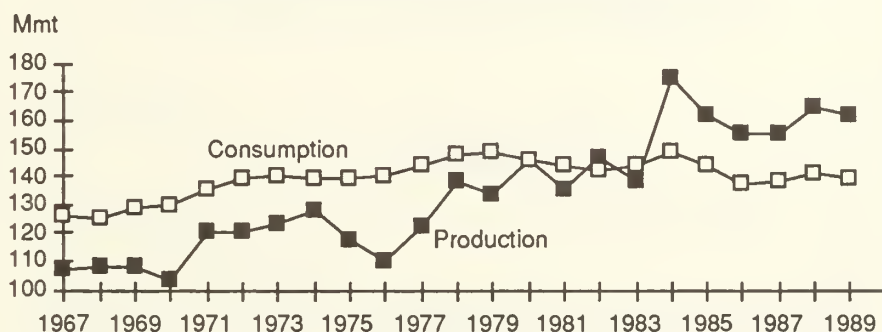


*EC dairy production between 1984 and 1989 has fallen 7 percent. Large stockpiles of dairy products, however, were dumped onto world markets at high budget costs.*

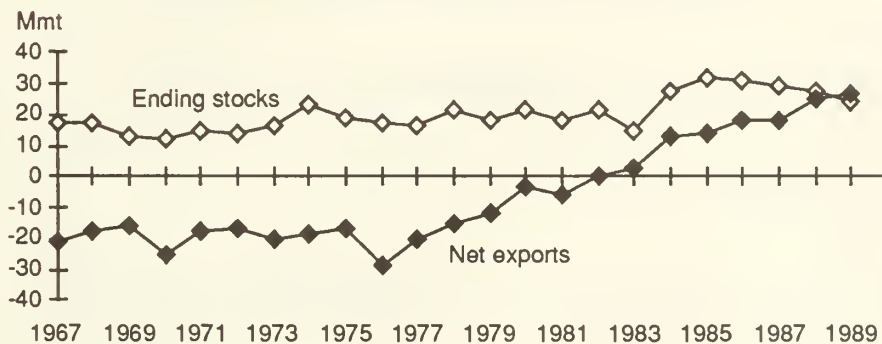
Question. *What have reforms to the CAP done for the grain sector?*

*Despite attempts to restrain prices and penalize production in excess of 160 million tons, EC grain production and net exports continue their long-run trend. Meanwhile, consumption continues to decline faster than trend.*

### EC GRAIN PRODUCTION AND USE



### EC GRAIN NET EXPORTS & STOCKS

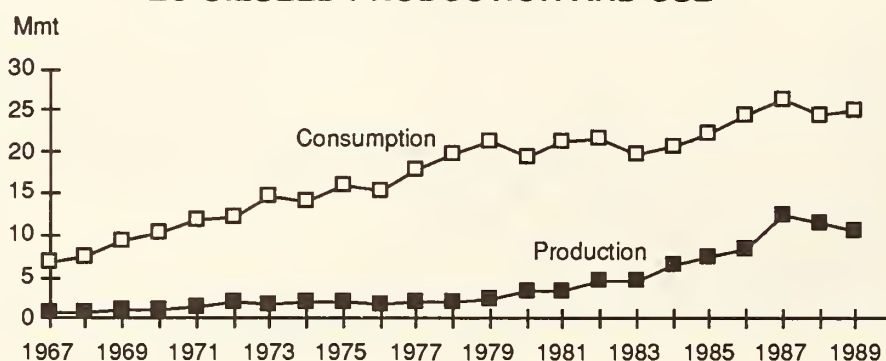


Question. What have reforms to the CAP done for the oilseeds sector?

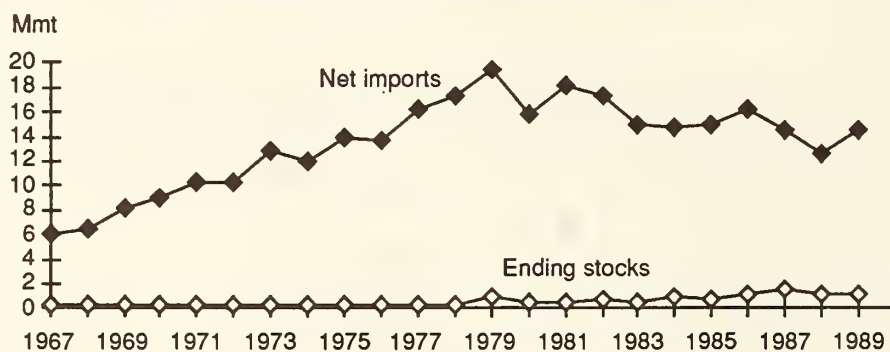


*Price restraint and the Maximum Guaranteed Quantity limits have slowed the growth in EC oilseed output since 1987, though growth is still above trend. Imports, however, continue to drop as EC crushing subsidies encourage the use of domestic oilseeds rather than imported.*

### EC OILSEED PRODUCTION AND USE



### EC OILSEED NET IMPORTS & STOCKS

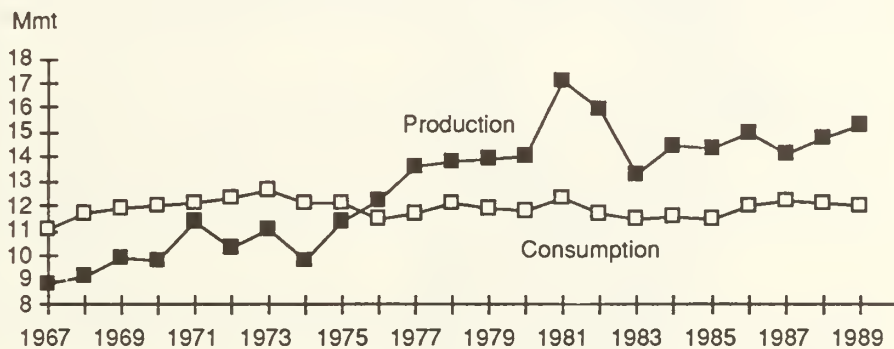


Question. *What have reforms to the CAP done for the sugar sector?*

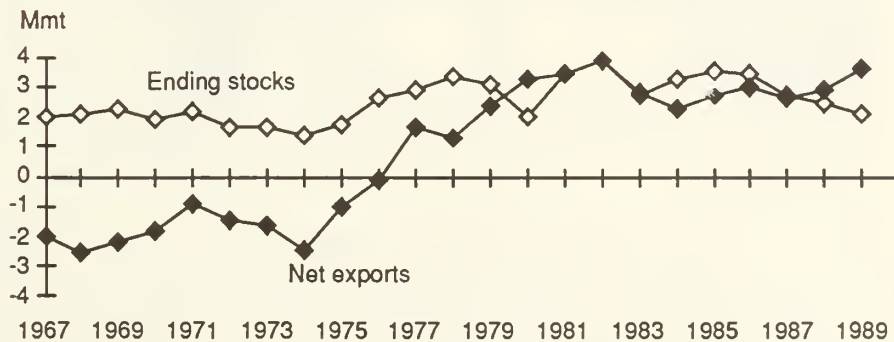


*Like dairy, the EC uses production quotas in addition to the basic mechanisms of the CAP to support the sugar market. After rising dramatically until 1981-82, EC sugar production and exports dropped sharply in 1983-84, but have risen since then.*

### EC SUGAR PRODUCTION AND USE

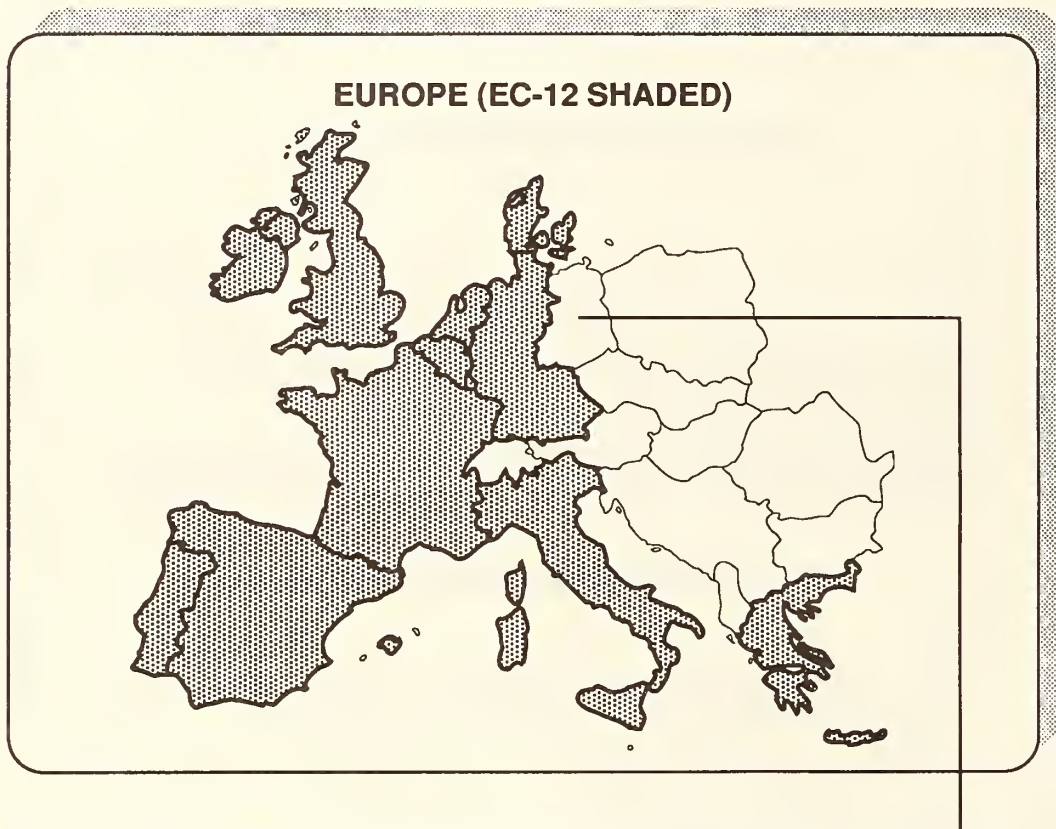


### EC SUGAR NET EXPORTS & STOCKS



Question. What does the future hold for the CAP and EC agriculture?

*The importance of restructuring agricultural policies around the world is high on the agenda of the Uruguay Round of trade talks in the GATT. This, combined with the EC's 1992 program to remove internal barriers to trade, will pose special challenges to the current support system provided by the CAP to the EC's agricultural sector.*



*Another issue is the impact of bringing East German agriculture under the CAP, and the future agricultural policies of other East European countries, who may seek to join the EC and adopt policies similar to the CAP.*

*The next page gives a short list of additional reading.*

### SUGGESTED READING

Agra Europe Ltd., **Agra Europe**. Weekly Newsletter on Agriculture in the European Community. London.

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